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U.S. House of Representatives
Committee on Energy and Commerce
Washington, DC 20515–6115

W.J. "BILLY" TAUZIN, LOUISIANA,
CHAIRMAN

July 29, 2003

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The Honorable Michael K. Powell
Chairman
Federal Communications Commission
445 12th Street, S.W.
Washington, D.C. 20554

Dear Chairman Powell:

We write to express our concern over the current TELRIC pricing rules. While the purpose of the Telecommunications Act of 1996 (the "1996 Act") was to promote private sector investment in competing networks and facilities, the current pricing rules do the opposite. They actively discourage investment, and, by doing so, undermine the health of the telecommunications sector and the national economy. There can be no doubt that government regulations have a major impact on the economic health and relative performance of the heavily regulated telecommunications sector. Furthermore, economic theory suggests and practical experience has demonstrated that firms will invest in new facilities only to the extent that they believe that the financial return over time from those facilities exceeds the cost. For this reason, we urge the Commission to promptly initiate a rulemaking to reform the pricing rules that apply when incumbent local exchange carriers (ILECs) are required to provide network elements to competitive local exchange carriers (CLECs) on an unbundled basis, and to complete this rulemaking on an expedited basis. We further urge the Commission to take immediate action to address the most egregious aspects of its pricing rules.

The primary problem is that the Commission's TELRIC pricing rules are based on hypothetical, ideally efficient networks rather than real-world network elements that must be provided to CLECs on an unbundled basis. By their very nature, the current rules discourage investment by incumbent telephone companies, which cannot recover their investment under the TELRIC methodology. The rules similarly discourage investment by competing carriers, who have little reason to invest when they can lease the existing network at artificially low prices and when any investment they do make can be undercut by other carriers who provide service leasing the incumbent's facilities at TELRIC rates.

FR, 1 AUG 2003

This problem has grown steadily worse in recent years, as the initial prices that states established under the Commission's pricing rules have been dramatically reduced based on more extreme assumptions about the imaginary network. Indeed, according to expert testimony before the House Subcommittee on Telecommunications and the Internet, investment by telecommunications carriers has declined by some $60 billion since 2000,[1] which corresponds with the period when prices set initially under TELRIC were slashed again. While other factors no doubt also contributed to this decline, the Commission's rules unquestionably were among the leading factors.

This problem is made much worse by the fact that the same pricing rules are applied when other carriers provide service entirely over the incumbent's existing network using what is referred to as the "unbundled network element platform" (UNE-P). Of course, the 1996 Act did not impose this requirement. Rather, the 1996 Act allowed other carriers to provide services using the incumbent's entire local network exclusively under a separate resale pricing standard. It was the Commission that created the UNE-P after the Act was passed, and it was the Commission that decided to apply its TELRIC rules rather than the resale pricing standard mandated by Congress. By doing so, the rules have created a classic case of regulatory arbitrage. Indeed, carriers using the UNE-P boast of gross margins ranging from approximately 50 to 70 percent, all without investing in any facilities of their own.[2] Meanwhile, the carriers that have invested in network infrastructure still bear the costs of maintaining their networks, but are paid for only a fraction of those expenses, because their costs are based on a hypothetical network. Indeed, according to a recent study, "while the Bells lose roughly 60 percent of the revenues when they lose a line to a UNE-P based competitor, we estimate that they retain 95 percent of the costs."[3]

We therefore urge the Commission to take several steps to address these problems. First, the Commission should promptly initiate and complete before the end of this calendar year a proceeding to reform its pricing rules for unbundled network elements. Such a timetable should not place an unrealistic burden on the Commission as the agency is intimately familiar with its existing rules and the manner in which they have been applied. Moreover, acting promptly is absolutely necessary to halt the damage being done by the current rules and to restore rational investment incentives.

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[1] *See* "The Health of the Telecommunications Sector. A Perspective of Investors and Economists," Hearing before the House Subcommittee on Telecommunications and the Internet, 108th Congress (testimony of Robert W. Crandall, Senior Fellow, The Brookings Institution), February 5, 2003.

[2] *See,* "American Discount Telecom, "50% to 70% Net Profit Available to Competitive Telephone Companies," http://a-adt.com.

[3] M. Grossman, et. al., J.P. Morgan Securities, Inc., Industry Update – No Growth Expected for Bells in 2003 (July 12, 2002)

Second, the Commission should make clear at the time it initiates this proceeding that it will no longer base prices on hypothetical, imaginary networks, but rather will base prices on real-world networks that are used to provide unbundled elements. Likewise, the Commission should announce that it will require the states to re-calculate the existing UNE rates using the modified pricing methodology promptly after the new rules are adopted. It is critical that the notice of proposed rulemaking assures investors that the Commission understands the seriousness of the problem and is committed to addressing it squarely.

Third, the Commission should move immediately to take interim steps to begin to limit the most harmful effects of its existing rules, including the effects of the arbitrage created by applying the current pricing rules to the UNE-P. It should stop applying the TELRIC rules to the UNE-P, and make clear that the resale-pricing standard prescribed by Congress provides the price floor. It is imperative that the Commission acts now to limit the harmful fallout until it completes the reform of its pricing rules later this year.

Mr. Chairman, we have examined the arguments in favor of the current pricing model and believe they are short-sighted. We understand that a number of recent state actions to aggressively slash TELRIC rates have permitted certain carriers to enter the local market and compete with the incumbent local exchange carriers. For the reasons stated above, this competition is illusory. Such pricing levels are not sustainable beyond the very short-term and will only serve to undermine investment and delay the emergence of true facilities-based competition. That result is not in the public interest.

Thank you for considering our request.

Sincerely,

W. J. "BILLY" TAUZIN
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